INDUSTRIAL BONDS AS AN INVESTMENT

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Some five years ago, in an article that was later published in the *Yale Review,* I went into a rather thorough discussion of the "industrial bond." In that paper I proved—to my own satisfaction, at least—that the industrial bond was a well-secured and attractive investment, and that the earning power behind it was greater than that behind the railroad or other corporation bond. Theoretically I still believe this to be true, and I shall presently present comparative figures to attest to the accuracy of this belief. But, looking at the matter from the viewpoint of the average investor—and the average investor has no large sums to invest and is not well informed in financial matters—the matter presents itself in a different aspect.

The first question the average investor asks about a bond is, "Is it safe?" The answer to this question in the case of the industrial bond involves more considerations than perhaps any other form of security. The earning power or the ability to pay the interest and, in due course of time, the principal must be considered in the industrial as well as in any other form of bond. But having satisfied himself as to this feature in the municipal bond, in the railroad bond and, in general, in the public utility bond, the investor need go no further. He can then buy the bond without misgivings. But in considering the purchase of an industrial bond the problem is different. The company issuing the bonds may be earning each year two or three times its fixed charges, that is, it may be making enough money to pay all the expenses of operation and management, the taxes, and insurance, enough to write off bad and doubtful accounts, to set aside a generous amount for depreciation, and to have left a balance sufficient to pay interest on its bonds two or even three times over.

Such a showing should surely satisfy the most cautious investor, could he be assured of the continued prosperity of the company, and be certain of a continued demand for its products. But wait. May not some other industrial company discover a better process for manufacturing these same goods, or enjoy some advantage in econo-

mies of operation, favorable railroad rates, something or other, whereby it can undersell or produce a better article? The automobile companies throughout the country are reported to be making money very rapidly (the 1905 census showed an aggregate output of 21,000 machines worth over twenty-six millions) and yet a twenty-five-year bond on an automobile plant could scarcely be called an investment of the most conservative nature. The automobile industry is too new, too unsettled, and the disastrous slump in the bicycle business is still too vivid in many minds. In 1900, bicycles to the value of twenty-two millions were manufactured in this country; in 1905, this output dropped to three and one-half millions. Bicycle bonds are very unpopular now.

It is this consideration, *i. e.,* the uncertainty of the future, that prevents so many of our industrial bonds from being desirable investments. For it must always be remembered that a stockholder is a partner while a bondholder is a creditor. In a new venture the stockholder may look for large and dazzling returns, but the bondholder can never hope for more than a certain fixed rate of interest on his money, no matter what success the company may win. Should failure result, both lose, though the bonds usually bring their holder something from the sale of the plant, machinery, etc. In popular parlance, the bondholder is "holding the bag" for the stockholder. This is the reason that it is difficult to float bonds on a new and untried industry. After actual results have been demonstrated it is easier for the company to borrow money. Sometimes this difficulty is avoided by giving to the bondholder a stock bonus, or gift, this bonus being anywhere from 10 to 100 per cent. So the investor who purchases $10,000 of bonds is given $1,000 to $10,000 of stock, the amount varying with the needs of the company and the shrewdness of the investor. This is, of course, treasury stock and costs the company nothing, but *presto chango,* the creditor is now also a stockholder and a partner and can share in the fat dividends that always look so alluring and so often prove a mirage.

It is the part of wisdom to be guided by the advice and the experience of others. In many states, and in nearly all the eastern states, the legislators have devised certain rules and restrictions governing the investments of savings banks and trust funds. The savings bank is pre-eminently the depository of the man with limited

means, and should be safeguarded with care and forethought. With amazing unanimity the different states have passed laws permitting the purchase of government and state bonds, municipal bonds of certain cities (with limits as to population and indebtedness), first mortgage bonds of dividend-paying railroads—but not of industrial bonds. The only eastern states that look with a kindly eye on industrial bonds are Maine and New Hampshire, and they frown on companies not doing business in the state.

The Maine law limits investments of this character to the bonds of those companies "incorporated under the authority of this state, and *actually conducting* in this state the business for which said corporation was created, which are earning and paying a regular dividend of not less than 5 per cent a year." This is clearly a provision to foster home industries. The New Hampshire law also limits savings banks investments in industrials to the bonds of New Hampshire companies, adding the provision that such company's "net indebtedness at the time of such investment does not exceed its capital stock actually paid in and remaining unimpaired."

Massachusetts, New York, Vermont, Connecticut, New Jersey and Pennsylvania refuse to countenance industrial bond investments for their savings banks. The western states in general make no restrictions of any kind, leaving the decision as to what constitutes a safe investment to the judgment of the bank officials. Such states as do legislate on this subject, as Ohio, Indiana, Iowa, Minnesota, Missouri, Nebraska and Wisconsin, bar out the industrial bond. Michigan permits her savings banks to invest in first mortgage steamship bonds, under very carefully drawn provisions. The steamer must be steel, the mortgage must not exceed half the actual cash cost, there must be an ample sinking fund, and full insurance must always be carried. This is again an effort to build up and encourage local industries.

The prospective purchaser of an industrial bond might well adopt some of these rules for his own guidance. He should make sure that the company is not a new one; that it shows net earnings for the past five years equal to double the interest charges; that the capital *actually paid in* is not smaller than the bonded debt; that the character of the company is such as to preclude the probability of a sudden decrease in the demand for its product and that the men in control of the company are men of good repute as to ability

and honesty. If he insists on these five requirements he can invest his money with reasonable certainty of an assured income and the return of his principal. It is possible that, even after these precautions, he may suffer a loss, for the *absolutely* safe investment is yet to be discovered. But he will have a reasonably safe investment.

A discussion of industrial bonds would be of little value if it were limited merely to pointing out a few simple "donts" for the investor. The subject is very interesting to the student and offers many opportunities for investigation and the collection of statistics. Our American industries are so vast, so widely distributed in so many different fields and phases of activity, so different one from another, that it is difficult to make generalizations about them. A fairly complete list of the kinds of industrial companies would take up nearly all of this article. The United States Census Bureau, in Bulletin Number 57, issued by the Department of Commerce and Labor, "Census of Manufactures, 1905," gives a list of 339 classes of industries, and some of these might be subdivided. In size they range from the colossal "United States Steel Corporation," the billion dollar steel trust, with annual gross earnings of five hundred million dollars and upwards and a bonded debt of a like amount, to the village tannery or the crossroad sawmill. So, therefore, when one speaks of industrial companies and industrial bonds, one must take into account the large and the small, the good and the bad. An excellent idea of this diversity of American industries may be obtained by the following summary (taken from Bulletin No. 57):

	Number of Establishments.	Capital Invested.	Value of Products.
Food and kindred products	45,790	$1,173,151,276	$2,845,234,900
Textiles	17,042	1,744,169,234	2,147,441,418
Iron and steel	14,239	2,331,498,157	2,176,739,726
Lumber	32,726	1,013,827,138	1,223,730,336
Leather	4,945	440,777,194	705,747,470
Paper and printing	30,787	798,758,312	857,112,256
Liquors and beverages	6,381	659,547,620	501,266,605
Chemicals	9,680	1,504,728,510	1,031,965,263
Clay, glass and stone products	10,775	553,846,682	391,230,442
Metals and metal products	6,310	598,340,758	922,262,456
Tobacco	16,828	323,983,501	331,117,681
Vehicles for land transportation	7,285	447,697,020	643,924,442
Shipbuilding	1,097	121,623,700	82,769,239
Miscellaneous industries	12,377	974,316,571	941,604,873
Totals	216,262	$12,686,265,673	$14,802,147,087

These figures are for "establishments conducted under what is known as the factory system, thus excluding the neighborhood industries and hand trades." This distinction omits 317,507 establishments, but they are all small, as their aggregate capital is only $1,185,769,698, or less than $4,000 per establishment. Exaggerated statements are often made as to the amounts of liquors and beverages consumed in this country. This table shows that the total value of liquors, beverages and tobacco produced in this country in a year is far less than that of chemicals and only five-sevenths that of leather—a minor industry.

The rapid growth of American industries is clearly shown in the statistics of the Census Bureau. The following figures are taken from the Census of Manufactures for 1905 and cover all industries in the United States:

	Number of Establishments.	Capital Invested.	Cost of Material Used.	Value of Products.
1905	533,769	$13,872,035,371	$9,497,619,851	$16,866,706,985
1900	512,254	9,817,434,799	7,345,413,651	13,004,400,143
1890	355,415	6,525,156,486	5,162,044,076	9,372,437,823
1880	253,852	2,790,272,606	3,396,823,549	5,369,579,191
1870	252,148	2,118,208,769	2,488,427,242	4,232,325,442
1860	140,433	1,009,855,715	1,031,605,092	1,855,861,676
1850	123,025	533,245,351	555,123,822	1,019,106,616

These figures are worth a little study. In these last fifty-five years of American history, the number of industrial plants or separate establishments increased not quite five times, yet the amount of capital invested has become over twenty-seven times that of 1850 —a clear indication of the combination and consolidation that has been so prevalent. A half century ago the "captains of industry," with half a billion dollars to do business on, turned out products valued at twice their cost in the raw, making a gross profit of 100 per cent. Nowadays, with nearly fourteen billion dollars invested the gross margin of profit is only seven billions, or 50 per cent. In other words, the gross profits have been cut in two. But by economies in management, utilization of by-products, and the systematization of every branch of operation, the net profits have, if anything, been increased.

Definite figures on this point would be interesting. One can tell almost to a penny how much the railroads earned last year, but

with the industrials it is practically impossible. I have made the following compilation from this same census report:

Salaries	$609,200,251
Wages	3,014,389,372
Miscellaneous expenses	1,651,603,535
Cost of material used	9,497,619,851
Cost of products	$14,772,813,009
Value of products	16,866,706,985
Profit	$2,093,893,976

This would show a profit of 15 per cent on the capital invested, but as Mr. S. N. D. North, the Director of the Census, pointed out to me, the statistics take "no cognizance of the depreciation of plant, the expenses incident to the sale of products, the interest on capital invested, the losses due to bad debts and reverses in general, and these are all very important elements in the accounts." Still, 15 per cent would cover all these items, pay interest on the bonds and leave a very comfortable margin for the stockholders.

In the opening paragraph of this article I made the statement that it was my opinion that the earning power behind the corporation bond was greater than that behind the railroad or other corporation bond. The following table, obtained from "Moody's Manual of Railroads and Corporation Securities," for the year 1907, throws some light on this point:

	Number ot Companies.	Stocks and Bonds Outstanding.	Total Capitalization (par value).
Steam Railroads	1,419 companies (222,013 miles of track).	$5,279,904,040 * 8,628,552,806 †	$13,908,456,846
Electric Railroads	1,109 companies (30,824 miles of track).	2,195,172,000 * 2,227,590,000 †	4,422,764,000
Gas, Electric Light, and other Public Utility Companies.	1,654 companies.	....	3,478,084,000
Industrial Companies	1,466 companies.	7,585,340,000 * 2,264,493,000 †	9,849,833,000
			$31,659,137,846

* Capital stock. † Bonded debt.

Now it should be noted that the steam railroads of the country have bonded themselves to the amount of eight and one-half billions,

while their entire capital stock is not much over five billions. The industrials show a capitalization of seven and one-half billions, while their bonded debt is less than half that of the railroads. Of course, it is easier to pay interest on two and a quarter billion of bonds than on five and a quarter billions, and the industrial bond (as a whole) is just that much stronger.

If the figures given for the capital stock represented the actual cash paid in, all that remains would be to add Q. E. D. For the industrials need only to earn 1½ per cent net on their capital stock to pay 5 per cent interest on their bonds, while the railroads need 8½ per cent to pay the same rate. And he must be pessimistic, indeed, who would say that the industrial companies of the United States cannot earn 1½ per cent.

The statistics of the census show different figures, but they seem to prove the same thing. After elaborate calculations covering many months, a special department of the census arrived at a commercial valuation of all the railways operating property in the United States of $11,244,852,000. This includes "terminal properties, ferries, bridges and the like used but not owned by railway corporations," and omits property owned but not used in the business of transportation. These figures would, therefore, be large for the actual value of the railroads themselves. But, as we have seen, the Census Bureau shows $13,872,035,371 for capital actually invested in industrial establishments, or an excess of two billion over the railroads.

The census presents no figures on the stock and bonded capitalization of the industrials, nor has the Census Bureau ever attempted to collect such statistics except at the census of 1900, when this information was collected for industrial combinations or trusts. At that time there was found a total capitalization of slightly over $3,000,000,000, with a total of only $216,000,000 of bonds issued, or about 7 per cent. This small percentage shows that industrial bonds were not in favor in 1900, and that the companies were financed by stock issues rather than by bond flotations. In fact, the industrial bond is rather a new thing, as the first issue that I can find was just forty years ago, in 1867, when the Lehigh Coal and Navigation Company put out an issue of 6 per cent first mortgage gold bonds. The next issue seems to be fifteen years later. Definite information on this point is difficult to obtain, but

it is safe to assert that very few industrial bonds were issued more than twenty-five years ago. Of late years bond flotations have become more and more common, and more and more popular with the investor.

The following table of bond and stock listings, taken from the "Financial Review" for 1907 published by the *Commercial and Financial Chronicle,* shows this clearly:

Listings on New York Stock Exchange

BONDS

1906	$303,112,000
1905	569,079,000
1904	429,810,500
1903	191,515,050
1902	197,516,313
1901	220,171,700
1900	147,678,597
1899	156,304,760
1898	245,219,480
1897	87,720,502
	$2,548,127,902

STOCKS

1906	$237,479,600
1905	125,123,300
1904	120,635,050
1903	172,944,200
1902	251,069,400
1901	429,537,450
1900	296,550,572
1899	311,420,285
1898	69,754,130
1897	53,275,671
	$2,067,789,658

This shows that in the last five years there were listed bonds to the amount of nearly double the amount of stocks. These figures include both railroad and industrials, and hence do not bear directly upon the matter in hand, save to show the growing custom of meeting capital needs by the floating of bonds rather than by the issuance of stock. An interesting reason sometimes given for this

is that the financiers who control the railroads and the great industrial corporations are fearful of increasing the number of their stockholders. For example, a man can control a million dollar corporation by owning $501,000 of stock; now suppose that corporation needs additional capital for improvements or the extension of its business to the amount of an additional million. If the money is raised by stock issue Mr. Capitalist is forced to go down into his pocket for another half million to keep control, but if the corporation can raise a million by selling its bonds, he can keep his control without further outlay. Wall Street remembers only too well the coup by which Mr. John W. Gates secured control of Louisville and Nashville, and more recently how Mr. Stuyvesant Fish was forced out of the presidency of the Illinois Central, and it is bent on keeping control, represented by the actual certificates, tucked away in its strong boxes.

This is one reason, of course, but the real reason is the broadening of the bond market, the more favorable interest rates and the wonderful absorptive powers our American investors are showing. But to go back to the relative earning power behind the railway and the industrial bond, there is clearly a difference of two billions of cash capital in favor of the industrials. As railroad bonds easily aggregate four times the total of industrial bonds, then the railways must earn four times as much as the industrials to pay the annual interest charges. As to which earn the most, railways or industrials, I have never seen any estimate. With a favorable tariff and almost complete monopoly in some lines of industry on one hand, and rate regulation and threatened government control on the other, it would seem fair to suppose that our industries make as much money as our railways. And with a bonded debt only one-quarter as large, the margin of safety seems to be all in favor of the industrial bonds.

It must not be lost sight of that this discussion is theoretical and not concrete; that the investor is not considering the purchase of all the industrial bonds, as against all the railroad bonds. What he does consider is a few bonds of a particular issue on a particular industry, and he must be guided by special rather than by general considerations. And while as a whole the industrials of the United States are to be compared favorably with the railroads as regards extent and earning capacity, still the fact remains, that individual

investments in railroad bonds are much less apt to be disturbed than individual investments in industrial bonds, for the reasons already pointed out. An industrial plant is usually limited to one location and makes one product; a railroad connects and supplies hundreds of localities and carries hundreds of products. Conditions which would vitally affect the industrial are of passing importance to the railroad. Similarly the holder of a municipal bond is spared many worries, which must beset the mind of the industrial bondholder, for the faith and credit of a city and all its resources are pledged to pay its bonds, and it is an old saying that "There's nothing certain save death and taxes." A property owner must pay his taxes and the taxes pay the interest on the city's bonds.

The industrial bond as an investment is attractive in the high rate of interest usually offered and the great earning powers often shown behind it, but its purchase requires care and investigation beyond that of almost any other bond. The industrial bond is young and already occupies an important place in the investment world. As time goes on, as industrial conditions become less liable to change, the American investor will more and more turn to industrial bonds as an attractive investment.